# Testimony, Senate Finance Committee

*Submitted by*
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## Introduction

Mr. Chairman: Thank you for the opportunity to testify on the issue of federal tax credits for employers offering health coverage. I am pleased that the Senate Finance Committee is exploring a range of options for expanding health coverage.

I would like to begin by noting that there is no one "quick fix" or panacea for the troubling and long-standing problem of the uninsured. This group of Americans is very diverse. It includes working families with low and moderate incomes, recent immigrants who are ineligible for public programs, older workers not yet eligible for Medicare, and many very poor adults without dependent children. There are also young adults who have "aged out" of their parents' health coverage. It is unlikely that one policy tool will meet the disparate circumstances of this heterogeneous population.

In this respect, I have been frustrated by the ideological battles over whether public programs or private sector initiatives are appropriate to reduce the number of uninsured. We need to fashion a strategic mix of policies that includes bringing more people into Medicaid and S-CHIP who are already eligible for these programs; extending eligibility to people with very low incomes (mainly adults) who are screened out of public coverage; strengthening our safety net; and helping the working uninsured find affordable insurance.

While the rhetoric features a "public *versus* private" debate, the reality is that many states are experimenting with ways to leverage public funds to shore up and extend private employer-sponsored coverage. We need to find ways to retain businesses that now participate in the health care system, and make employer health care contributions more affordable for many small and medium-size employers who now sit on the sidelines. We can get a good "bang for the public buck" by using limited public resources to solidify and strengthen the employer-based system. At the same time, we need to bring into our public programs some very vulnerable people who are not engaged in the work-based system.

## The Role of Tax Credits

Federal tax credits can play a role in expanding coverage. I would like to see such credits placed within a framework of major reform in the tax treatment of contributions to health coverage, rather than as an incremental add-on to a system of tax subsidies that is very inefficient and inequitable. The tax provision that allows workers to exclude from taxable income the amount that employers contribute to worker health premiums has been estimated to drain about $141 billion from federal and state coffers. Moreover, the exclusion is very regressive. It dishes out large tax breaks to upper-income households even as it bypasses many lower-income working families with little or no tax liability. The current tax treatment of health care contributions also pumps up health care spending by insulating people from the real cost of their coverage and underwriting a large portion of the excessive costs of inefficient health plans and care systems.

Limiting this exclusion could provide a substantial source of revenue that could be used to extend health coverage to the uninsured. I hope that the committee will explore options to convert this inefficient and inequitable system into a set of fixed-dollar, refundable tax credits that would better target public dollars to actual need and add a measure of cost discipline to the health care system. A refundable income tax credit would be a much better use of public funds than a deduction for health care expenses for individuals who are uninsured. Very few Americans in financial need would benefit from a deduction.

### *Who Gets the Tax Subsidy?*

In theory, it should not matter much whether we offer tax credits to employers or employees. Most economists believe that it is the size of the *total* compensation package that matters to employers. There is a maximum total amount that is optimal to recruit and retain the work force they need to produce their goods and services. If the cost of one element of the compensation package (e.g. health care) increases, they will lower their spending for other elements, such as wages or contributions to pensions, and vice versa. In this framework, when employers write a check for health coverage, they are not really spending their own money, but the workers' money.

In practice, however, the choice of whether to offer credits to employers or employees may matter. Employers may be more responsive than workers to a change in the real price of health coverage. In other words, their "take-up rate" may turn out to be higher. Several studies have examined the responsiveness of employers to a reduction in the price of health coverage, which is the effect of the tax credit. One group of studies uses variations in tax rates across states to determine the impact of after-tax prices on small firms' willingness to offer health coverage. Estimates of the price elasticity in this group of studies ranged from –0.63 to –2.9, indicating a strong response by employers to price changes. In other words, if price declines by 1 percent, the quantity of health insurance purchased should increase by somewhere between slightly less than 1 percent and nearly 3 percent (Gruber, 1999). Furthermore, while workers do not need an offer of coverage from their employers to obtain it, they will pay substantially more if they buy coverage on their own than if they enroll in group coverage. Thus, I will proceed under the assumption that it is worth considering direct subsidies to employers because they might provide better results per dollar invested than subsidies to employees.

Of course, as noted earlier, both types of subsidies could be used in tandem. This is not an "either/or" situation. We can combine tax credits for employers with a companion set of credits for employees, in order to work on improving both the employers' offer rate and the employees' acceptance rate. Again, some may say that this is a distinction without a difference, but in practical terms, it may be necessary to develop inducements that at least appear to be directed at both parties. Massachusetts has developed a two-part program that combines these two elements—the Insurance Partnership and the Premium Assistance Program. These programs, along with other state and local initiatives to bring more uninsured workers and their families into employer-sponsored coverage, are described in detail in two recent reports that my research team has prepared.

### *A Tax Credit for Employers*

My research organization, the Economic and Social Research Institute (ESRI), has prepared reports on federal tax credits for employers to offset a portion of the cost of contributing to health insurance. This work was supported by The Commonwealth Fund. One report, prepared by Sharon Silow-Carroll at ESRI, presents the lessons learned from reviewing employer tax credits tried by several states over the past decade. Key findings are as follows:

- Amount of subsidy: The amount of the subsidy must be substantial (for example, at least half of the premium, or about $1,200 for individual coverage and $3,000 for family coverage) in order to provide adequate incentive to employers.

- Awareness: There must be a strong publicity campaign to reach small businesses that do not offer coverage; this requires a significant front-end investment in sophisticated marketing efforts.

- Duration of subsidy: Tax credits or subsidies provided by states have generally been designed to phase out after a few years; i.e., they are meant to "jump start" coverage rather than provide ongoing support. While this makes sense from budgetary and fairness standpoints (ongoing subsidies are costly and unfairly penalize firms that had been providing coverage with no subsidy), small firms are wary about making a new commitment knowing that they will lose the financial assistance in the near future.

- Eligibility requirements: If the tax credit is not available to the business owner and his/her family, the firm is much less likely to newly offer coverage to employees. Also, if eligibility is contingent on a firm's not having offered health benefits over a long prior period, this will limit participation.

Our research has also convinced us that tax credits, whether for workers or their employers, must be accompanied by a place to take them with affordable prices. Throwing tax credits into existing insurance markets, especially the individual market, might leave many people far from affordable coverage. Compared to what large groups pay, coverage in the small-group and the individual markets is more expensive for a number of reasons: small buyers have no negotiating leverage; insurers experience administrative diseconomies; and risks are not as widely spread over large pools. There are promising solutions to these difficulties—including risk-adjustment of premiums to compensate health plans that have disproportionate numbers of high-risk enrollees, limits on insurers' ability to vary premiums based on enrollee health risk, and purchasing pools to give small purchasers some of the bargaining power that large purchasers enjoy. Past experience shows, however, that purchasing cooperatives have to be large to produce savings. Thus, incentives need to be put in place to encourage people to purchase tax-subsidized coverage through them.

One final consideration is that tax subsidies received at the time of tax filing do not provide either families or small businesses with the cash needed to make health premium payments throughout the year. For low-income families or companies with limited cash flow, the tax credit could be advanced at intervals during the year (Meyer et. al., 2000).

My colleague Elliot Wicks and I have developed a proposal to provide federal income tax credits to employers for contributions to health care. This proposal is described in detail in a report prepared for The Commonwealth Fund, which I submit for the record.

The features of this proposal are designed to increase the likelihood that this employer tax credit strategy will succeed in substantially reducing the number of working uninsured while containing the cost of the program.

### *Key Design Features*

1. The credit is available to all low-wage firms—those with average wage levels below $10 per hour—and graduated so that the amount of the credit is largest for firms with the lowest average wage.
2. The credit is permanent—that is, available as long as the firm meets the low-wage test of eligibility.
3. The credit is a large enough proportion of the cost of health coverage to induce a meaningful take-up rate among employers and their employees.
4. The credit is set at a fixed-dollar amount.
5. The credit is tied to the price of a "Standard" cost-effective benefit package.
6. The credit is uniform across the nation.
7. The credit is updated annually by repricing the Standard benefit package.
8. Firms must contribute toward the premium an amount equal to at least 50 percent of the cost of the Standard benefit package.
9. Employers taking the credit must offer coverage on the same basis to all full-time workers; coverage offered to part-time and temporary workers, though not mandatory, qualifies for the credit.
10. The credit amount is different for single and family coverage.
11. Firms are required to show proof of the amount they contribute to coverage when they file their income taxes and claim the credit.
12. Firms can claim the credit in installments rather than waiting until they file their annual income taxes, and the credit is refundable if the credit amount exceeds the firm's tax liability.

Our suggestion that the tax credit be made available to firms that already offer health coverage along with those newly offering is related to our decision to make subsidies permanent. Unless subsidies are available to firms already offering coverage, these firms and their workers would be treated inequitably. Workers in these firms have presumably foregone some wages or other benefits to obtain health coverage through the workplace. Thus, they have sacrificed their ability to buy other goods and services, and arguably are in need of assistance as much as workers who are uninsured (who may have a bit more money to spend on those other items).

Yet, I must note that this decision to "level the playing field" across these two types of workers carries a price tag for the government. A proposal targeting only those firms newly offering coverage would be less equitable, but also less costly, in strict budgetary terms.

Partially offsetting this added cost is the provision that limits subsidies to low-wage firms. Excluding higher wage firms is justified by the fact that a high proportion of uninsured people are employees of low-wage firms. Most higher-wage firms offer coverage; so providing subsidies to them would add few people to the insurance rolls.

I conclude by reiterating that federal tax credits for companies could be one important weapon in the arsenal needed for a successful attack on the multi-faceted problem of the uninsured in America. We should develop a comprehensive reform strategy that addresses the diverse needs of our population and builds cost discipline into the package.

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